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# *American Outlook*

# America rides out the storm



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WITH markets engulfed by the tidal wave of currency contagion, America looms all the more prominent as a bastion of stability. Yet in a world awash with fears of deflation and depression, investors are convinced it is only a matter of time before the global disease brings America to its knees as well, *writes Stephen Roach.*

Those fears are overblown. From Thailand to Russia - and many points in-between - there can be no mistaking the symptoms of a global currency crisis. Yet, ironically, America stands more to gain than lose from this chaos because this shock has spawned economic forces that have strikingly disparate impacts on its economy.

There is one big problem - its widening trade deficit. But this is outweighed by gains such as falling interest rates, reflecting the flight-to-quality rush into American treasury bonds, and the lower inflation produced by cheaper Asian imports.

Despite Asia's crisis, America's gross domestic product (GDP) showed 3.5% growth in the first half of 1998, little different from the 3.7% pace of the preceding 2 1/2 years. And there is likely to be more of the same.

Asia's crisis does matter. It has caused shifts in the sources of American growth. For example, in the first half of 1998, a deteriorating trade balance knocked 2.3 percentage points off GDP growth. Ironically, 75% of this was due to surging imports, a by-product of the strength of domestic demand. The rest came from weak exports, hardly surprising in light of what ails many of America's trading partners.

But America remains a relatively closed economy. Exports account for only 10% of GDP, and less than one-third go to Japan and other Asian countries. That limits the impact of this external shock on the economy.

Significantly, had it not been for the Asian-related hit to trade, growth would have been nearly 6% in the first half of this year. For a tight labour market - with unemployment at a 30-year low - such a boom and the resulting pressure on wages and inflation would have prodded the Federal Reserve into action. The resulting monetary squeeze might have set in motion the classic cyclical forces that eventually produce recession. From that standpoint, the Asian crisis came just in time, allowing a super-hot economy the chance to vent excesses without central-bank intervention. Courtesy of this shock, an already long-lived expansion was given the rare opportunity to reset the ever-ticking cyclical clock.

America's resilience is largely a by-product of the forces shaping its domestic economy - and the sharp interest-rate cuts stemming from the Asian crisis have provided a spur in fields such as consumer durables, housebuilding and corporate capital spending. Collectively, these sectors account for 27% of GDP, more than 2 1/2 times the export portion. With long-term interest rates down by more than one percentage point in the past year, these three sectors showed 15% growth in the first half of 1998.

The same can be said for an Asian-related compression of inflation in the tradable-goods sector. With falling import prices pushing the goods portion of inflation down close to zero by mid-1998, consumers' dollars have gone further. Partly as a result, spending on soft goods and services, which account for 59% of GDP, grew 5% in the same period.

Thus the arithmetic of Asia's crisis, to the degree that it affects America, is skewed towards resilience, not weakness: the impetus from the 86% of the economy that has benefited from lower interest rates and inflation has been more than sufficient to swamp the negative effects of a widening trade deficit bearing down on a much smaller external sector.

Nor does it seem likely that America's resilience is about to fade. That is because the underpinnings of domestic demand remain largely intact. A recent Manpower jobs survey says hiring plans are headed for a new cycle high in 1998. That suggests that job creation and income generation will remain vigorous, sustaining consumer demand. Moreover, the imperatives of productivity enhancement and heightened global competition seem likely to provide further impetus to corporate capital spending well into 1999. And manufacturing is about to benefit from a big rebound following the end of the General Motors strike and from the end of last spring's round of destocking. So it is onward and upward in the growth sweepstakes.

The markets are flashing a different signal. Wall Street's economically sensitive sectors - capital equipment, oil services, metals and farm equipment - have taken an extraordinary beating and are now priced for recession. Similarly, the fixed-income markets are discounting a Fed interest-rate cut to combat the coming downturn. And, at the same time, bond yields imply a further big and sustained fall in inflation - an outcome that might be forthcoming only in a prolonged and deep recession.

Alas, financial markets have long been prone to extremes. Legend has it that the stock market has correctly anticipated ten of the past five recessions. Currency crisis or not, my hunch is that this is another one of those false alarms. The underlying fundamentals of growth remain intact. With America a full fifth of world GDP, such an outcome should do wonders to counter the darkness now enveloping a seemingly battered global village.

- *Stephen Roach is chief economist and director of global economics at Morgan Stanley Dean Witter*

**Irwin Stelzer is away**

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